Sixtieth Lesson

On Being Right Too Soon

Certain Fallacies That May Prove Costly to the Unsophisticated Chart Reader.

Premature purchase or sale of stocks can cause the inexperienced speculator ugly losses. He may be right on the long pull but if he makes his commitment too soon, particularly when not too well fortified with sufficient cash to sustain brokerage demands, he may find himself in the unenviable position of taking his loss first and then seeing his stock proceed along the lines which he originally expected. This article gives some very helpful pointers on the subject and is well worth reading by amateur speculators and others.

IT is often said that over 95% of the speculators who enter the stock market lose their money within a short time. This applies not only to those who attempt to trade on tips, but also to those who think they are using most scientific and up-to-date methods in reaching their conclusions.

For example, let us consider the ordinary unsophisticated chart reader, and the manner in which he probably approaches his problem. A chart of the average price of a large number of active stocks, over a period of several years, will indicate when the market is relatively high or low, but it will not at any particular time show that the market is at the top or at the bottom.

The ordinary chart is a record of past history. It shows when a stock has been in an upward trend, when it has been declining, and when it has been fluctuating within a narrow trading range, or moving approximately in a horizontal direction. It does not indicate to everyone just what the stock is likely to do next, but it may offer, to those who are experienced in its interpretation, a significant suggestion as to the probable subsequent trend.

If the average market is at a relatively high level, and the particular stock under investigation is selling at a level which compares with its previously established record prices, and the price fails to make further progress after a substantial and rapid advance, it is probable that a reversal in price trend is approaching. The chart reader observes this indication, and he may jump to the conclusion that the stock is a good short sale. What he usually fails to consider at this point is that hundreds of other chart readers may have reached the same conclusion at about the same time. Others who may believe the stock is worth more, are willing to buy it at the market, or on a small recession, or on the first indication of a further advance. This naturally is an important consideration.

Of those who are willing to sell the stock short, some have sold with a two-point stop, others with a three-point stop, still others with a five-point stop, some with a stop at what they consider a "critical" level, and finally those who sell without any stop-loss protection on the present assumption that they will be willing to "ride through" any ordinary bulge that is likely to take place from current levels. All of these short sellers are potential buyers, and many of their bids are already placed at various levels above the market. This immediate situation means that the stock which appears to be turning heavy, according to the chart, is actually in a strong technical position.

Therefore, our trader's position may be premature. At this typical juncture his chances of loss are much greater than his chances for profit. If the stock in question has investment quality, or if the market is comparatively thin and the floating supply is small, or if the outlook for earnings is better than under similar previous conditions, or if certain interests are likely to desire control by purchasing stock in the open market, or if a pool is interested in manipulating the stock, or if other factors are about to operate in favor of higher prices, the unfavorable chances involved in the short position are multiplied.

Suppose our stock has worked out of its trading zone and has just entered new high ground. If it jumps ahead ten points and then hesitates, our bearish trader sometimes thinks it is ready to be sold again. This impulse may again be wrong, because it may overlook the fact that owing to considerable absorption of offerings in the recent trading zone, the floating supply may have become much thinner for the time being, and the technical position actually strengthened, in spite of the contrary indication offered by the uninterpreted chart.

When is it safe to sell? A chart alone will seldom give a decisive answer to this question. However, after the chart shows that the stock has made repeated unsuccessful efforts to advance into new high ground, and also shows that new weakness has developed during several consecutive reactions, then it may be logical to take a short position on a subsequent rally that fails to hold its ground.

The point we wish to make is that when the market appears to be relatively high, there is danger of taking a short position too soon, not only once, but several times before the price structure is actually ready to give way. It is safer to await ample confirmation of weakness before taking a short position, even if the profit secured is far short of the theoretical 100%.

If the above general reasoning is completely reversed, we have a picture of the corresponding situation near the bottom of the market, when amateur traders are trying to determine when to begin to accumulate stocks. It should be remembered that if a trader can be "burned" by a premature short position during the fireworks at the top of a bull market, it is equally probable that at the other end of the scale his financial vitality may be lowered by a series of sinking spells which are often preliminary to a genuine recovery.